Global Counsel

The EU Emissions Trading Scheme: putting the soft in soft power?

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Summary

- In the last two weeks the European Commission has proposed further tightening for the EU's flagship Emissions Trading Scheme (EU ETS) to try to raise European carbon prices. At the same time, it announced that it would suspend for a year its plan to extend the scheme to include foreign airlines. Both are important evolutions in the EU ETS story.

- These developments obviously tell us about the problems that have beset the EU ETS – both as a market mechanism and as a climate change policy export. But they will also provide some insight into the state of the domestic politics that ultimately props up – or does not prop up – the EU's appetite for global leadership on climate change.

- Europe's global climate change ambitions rely on its shaky ability to sustain its commitments domestically. But that domestic commitment will also reflect the coalition that it is able to build internationally through its own leadership. As the EU ETS debate suggests, that feedback loop for European climate change policy is now probably driving against ambition rather than for it.

- Will EU industry and EU politicians continue to back aggressive domestic policy on climate change when EU action can barely budge the global dial? It may not be spoken explicitly yet, but this is the question that hangs over European climate change policy.

Alongside the EU's carbon emissions targets, the creation of the world's largest carbon market is the EU's flagship policy response to climate change. It has however been dogged by carbon prices too low to drive industrial change and undermined by a persistently hostile response from parts of EU industry and the EU's international trading partners.

In the last two weeks this story has moved on in two important ways. First, the European Commission has outlined a set of proposals to boost the price of carbon emission permits, the European Union Allowances (EUAs) – proposals that were immediately criticised by industry in the EU's largest carbon emitter, Germany. Second, under international pressure, the Commission has postponed the inclusion of foreign airlines into the EU Emissions Trading Scheme (EU ETS) for one year, pending progress on an international deal to cut global carbon emissions from air traffic.

These developments obviously tell us something about the problems that have beset the EU ETS – both as a market mechanism and as a climate change policy export. But how these problems are tackled will provide insight into the state of the domestic politics that ultimately props up – or does not prop up – the EU's appetite for global leadership on climate change. For investors monitoring the state of the multilateral consensus on targets and collective action to tackle climate change, this is important.

The carbon price problem

Since being launched in 2005 the EU ETS has been one of the central pillars of European climate change policy. The system aims to impose a price on carbon by obliging carbon emitters to obtain EUAs for their emissions which can then be traded in the marketplace. This is the centrepiece of European attempts to 'internalise' the cost of carbon in a way that drives industrial and commercial change. Phase 3 of the scheme begins in 2013, in which the scheme will be expanded and as a result approximately half of the EU's greenhouse gas emissions will be covered.

The scheme's problems started with the free allocation of initial allowances for emissions based on pre-crisis usage trends. As economic activity has slumped this has produced a surplus of allowances and collapsed the EUA price. In total, by early 2012 the surplus of allowances above the volume of emissions was almost 1 billion. As a result the price of carbon in Europe has fallen to around €7-8/tonne, far below the price of around €30/tonne which is estimated to be required to drive innovation and efficiency (Chart 1). Stalled emissions levels mean that the surplus during phase 3 could rise up to 2 billion.

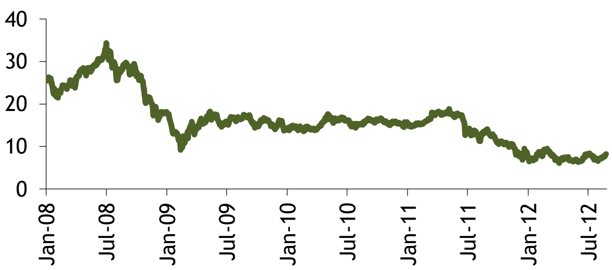

Chart 1: price of EUAs (€)

Source: European Environment Agency

To address the surplus in phase 3 the European Commission has proposed an amendment to Regulation 1031/2010 in which 900 million allowances in total will be removed from the auction of new allowances and fed back in 2019 and 2020. Whilst this will undoubtedly help support the price of allowances, analysts have generally concluded that this widely anticipated 'backloading' measure is already priced into the market.

From 2015 the agreed linkage with the Australian carbon emissions trading scheme is also expected to give a small boost to the market as Australian carbon emitters provide a source of additional demand. However, when European producers eventually become able to buy Australian allowances this short term boost in demand could well be cancelled out by a medium term injection of supply.

Brussels displays a range of views on the EU ETS that run from the sanguine to the downright sceptical. Optimists will tell you that the creation of the market itself is what matters – the pricing function will come right with time. Sceptics worry that the apparent failure to create a carbon price that drives change is undermining international perceptions of the viability of market mechanisms for putting a cost on carbon externalities.

Brussels' instinct will be to keep tightening the market. Proposals floated in Brussels to raise the EUA price in the longer term include raising the overall European carbon emissions reduction target to 30% by 2020 and increasing the linear annual rate at which permits are withdrawn from the system from 1.74% to tighten the market. Backloaded allowances could also ultimately be cancelled to effect a permanent reduction in the number of allowances.

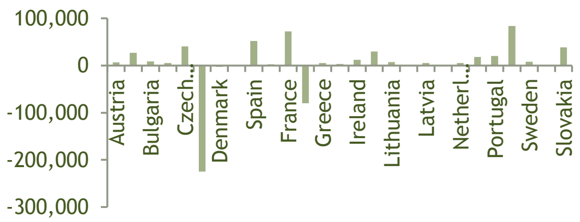

Chart 2: Net EUAs (freely allocated EUAs minus verified emissions) in EU ETS trade phase 2 (2008-2012) (thousand permits)

European Environment Agency

Levels of political opposition to or support for these proposals will be crucial, and are likely to be heavily shaped by the perceived weakness of the European economy. Germany's large manufacturing base will make it uneasy about raising the price of EUAs, as will the uncertainty about the future of its power sector, which is in the process of phasing out nuclear power. Persistently high levels of coal consumption over the last few years has seen Germany, alongside the UK, become one of the few emitters to receive fewer EUAs than it emitted over the second trading phase between 2008-2012 (Chart 2). The objections of the German Steel Industry Association, which quickly came out against the measures citing damaging effects on German competitiveness, are likely to be echoed by manufacturers across Europe. As economies struggle to recover, this will test the resolve of European leaders.

Flying into rough weather

The other key dimension of phase 3 of the EU ETS is the extension of the scope of the scheme to new categories of emissions. This was due to include all flights either landing in or taking off from within the EU. Aviation emissions account for around 3% of the EU's total emissions but are due to grow rapidly as global flight volumes increase.

Emission allowances for airlines under the scheme were to be capped at 95% of the average total industry emissions from 2004-2006. 82% of these would be made available free of charge, 15% were to be auctioned and 3% to be set aside for new entrants and fast growing airlines. Only 1.5% of emissions were to be allowed to be offset with international credits. Failure to comply with the scheme would result initially in a penalty of €100 per tonne of CO_2 not covered by an allowance, with the uncovered emissions carried over to the operator's total for the following year. Ultimately non-compliance could in extreme cases lead to the detention and sale of aircraft and even banning of certain airlines from European airspace.

Although the plans were strongly criticised on their announcement in 2005, the Commission estimated that the new system would add only €2-12 to the price of a ticket, and that efficient airlines could actually profit from selling allowances. The proposals have already survived a legal challenge from a number of international air travel bodies that argued that the expansion of the EU ETS to aviation was a contravention of the Chicago Convention, the Kyoto Protocol and the US-EU Open Skies Agreement. The case was dismissed by the European Court of Justice in December 2011 which concluded that the EU was not a party to the Chicago Convention, and that the Kyoto protocol is not sufficiently precise to be relied on in contestation of EU law. It also ruled that as the EU ETS only applies to airlines registered in member states, or choosing to operate in member states, it infringes on neither the territoriality nor sovereignty of third party states.

All the same, the EU proposal managed to achieve the unusual feat of placing the US, China, India, Brazil and Russia all on the same side of an international issue. Both US houses of Congress passed legislation banning US airlines from complying. China banned its airlines from complying, and in total eight of its airlines, thought to include Air China, China Southern and Hainan Airlines, refused to submit flight data to the Commission, as well as Indian airlines Air India and Jet Airways. European aircraft manufacturer Airbus had also reported that a number of deals to sell passenger aircraft to Chinese airlines had been blocked in an apparent response to the inclusion of aviation in the EU ETS.

EU Commissioner for the Environment Connie Hedegaard announced this week that the EU would postpone the inclusion into the EU-ETS of flights to and from non-member states until September 2013 (although the measure will be implemented for internal EU flights). This was explicitly linked to the decision of the International Civil Aviation Organisation (ICAO) to establish a high-level group to work on and introduce a global scheme to reduce carbon emissions from aviation. Hedegaard said failure to demonstrate significant progress multilaterally would result in a resumption of the plan.

The Commission has presented the decision to defer the expansion of the ETS to foreign airlines while a global consultation is attempted as ‘multilateralising’ the process. But ultimately the decision may simply be deferring the inevitable disagreement, and leave Hedegaard and the European Commission once again in the unenviable position of choosing between a diplomatic row and action that imposes costs on European businesses that do not apply to their competitors. While some in the Commission affect to see little connection between the international acceptance of the EU ETS and its domestic role and value, there is obviously a degree to which domestic support for the costs it imposes are balanced by its success as a policy export. This is not a trivial point, and it is the bigger issue that binds these EU ETS angles together.

Putting the soft in soft power

The EU has consistently positioned itself as a global leader on action to tackle climate change – indeed the issue has been one of the few areas in which the EU has developed a consistent foreign policy platform. Alongside the promotion of human rights and democracy the climate agenda is a central part of the EU’s self-image as a soft power – a global projector of ‘post-material’ multilateral values. But critical to the EU’s ability to provide global leadership on climate change are two interrelated intangibles: internal European consensus and international credibility. Whilst last week’s changes do not necessarily undermine the EU’s ambitions, they do point to troubles ahead.

Europe is entering an important phase in its programme to combat climate change - in particular as it begins to formulate carbon emission reduction and renewables targets beyond 2020. Whilst the Commission remains convinced of the need for greater reduction in emissions – and indeed are pushing to increase the target for reductions to 30% by 2020 – they are increasingly dealing with member state politicians unenthusiastic about the realities of imposing the short term costs of such a strategy on businesses and consumers. Especially in the absence of parallel international commitments.

Although this is hard to measure, the political power of climate change to trump short term competitiveness concerns in the EU has arguably declined sharply over the last five years as macroeconomic conditions have deteriorated. These days, you are much more likely to hear Europe’s energy policy ambitions framed in Brussels in terms of energy security than climate change. Resistance to the Commission’s attempts to tighten the EU ETS carbon market will provide an interesting barometer of the extent to which macroeconomic and political realities are undermining Europeans’ desire to be an international climate frontmarker in action as well as words.

Europe’s strategy leading up to Durban, as in the last round of WTO multilateral trade talks, was to offer more than anyone else in the hope that this would encourage ambition in others. Such a strategy of course relies on the EU’s shaky ability to sustain this commitment domestically. But its domestic commitment will also reflect the coalition that it is able to build internationally through its own leadership. As the EU ETS debate suggests, that feedback loop for European climate change policy is now probably driving against ambition rather than for it.

The EU has expended a great deal of political capital in the UNFCCC process, in return it has seen very little concrete gain (See GCI Disagreement deferred at Durban). At the UNFCCC COP 18 in Doha which begins today we will see to what extent the EU is still willing to play the lead role on climate change. But the realities of climate change may be shifting opinion both in the EU and outside of it. Even if the EU wants to remain a frontmarker, by 2030 its share of global emissions could be as low as 4%, which means that its relevance in global debates is likely to be proportionally weak.

European action on climate change has been predicated on a political calculation that raising the ambitions of the rest of the world was worth the costs of being the frontrunner. This calculation is now being challenged on two fronts - by the economic downturn in Europe, and the continued intransigence of other large global players. Will EU industry and EU politicians continue to back aggressive domestic policy when EU action can barely budge the global dial? It may not be spoken explicitly yet, but this is the question that hangs over European climate change policy.

38 Wigmore Street
London
SW1U 2HA
info@global-counsel.co.uk
+44 (0)207 656 7600